United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-7503

United States Court of Appeals
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SUSAN TANNENBAUM,
Plaintiff-Appellant,

against

ROBERT G. ZELLER, *et al.*,
Defendants-Appellees.

BRIEF FOR PLAINTIFF-APPELLANT

Abraham J. Brill
Attorney for Plaintiff-Appellant
10 East 40th Street
New York, N. Y. 10016
(212) MU 3-0107

Of Counsel:

Leonard I. Schreiber

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Docket No. 75-7503

SUSAN TANNENBAUM,

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This stockholders' action, brought derivatively on behalf of defendant Chemical Fund, Inc. ("Fund"), was tried without a jury before Hon. Robert L. Carter, United States District Judge, on December 16-18, 1974. Plaintiff appeals from a judgment entered in the District Court for the Southern District of New York on August 1, 1975, dismissing the complaint.

The opinion of the District Court (A-51*) has been published in CCH Fed. Sec. L. Rep. at Para. 95,257 and at 399 F. Supp. 945**.

Questions Presented

1. In applying excess brokerage commissions for their own benefit rather than recapturing such commissions for the benefit of the Fund did defendants:

(a) breach their fiduciary duty to the Fund?

(b) breach the Fund's management and distribution agreements?

(c) violate certain provisions of the Fund's certificate of incorporation?

The Court below held that, inasmuch as the possibility of recapturing excess commissions had been fully disclosed to the unaffiliated directors of the Fund and the

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* The Joint Appendix is divided into two parts, Part A contains pleadings and other papers in the court below. References herein to those papers are indicated by the letter "A" followed by a page number. Part B contains the trial transcript and trial exhibits. References to the transcript are indicated by "Tr." followed by a page number. The original page numbers have been retained. Exhibits are referred to by their original numbers and may be found in the Appendix by reference to the Table of Contents.

** Pursuant to direction of the Court, the trial of the action was confined in the first instance solely to the issue of liability. (Tr. 284-85).

latter had, in the exercise of a business judgment, determined not to require recapture, defendants were not liable under the federal securities laws or at common law.

> 2. Did defendants adequately disclose in the Fund's proxy statements and other reports filed with the Securities and Exchange Commission and distributed to investors that excess brokerage commissions were being applied for the benefit of the Fund's investment adviser and principal underwriter which, at all times, could have been recaptured and applied for the benefit of the Fund?

The court below did not squarely address this issue, having held that it was sufficient that the Fund's prospectuses disclosed (a) that the Fund allocated brokerage commissions to unrelated third parties as a reward for selling Fund shares and providing research and statistical services and (b) that the Fund, as a matter of policy, would not use the corporate parent of its adviser as an executing broker. The court below did not advert to the fact that the prospectuses, proxy statements and other reports issued by the Fund uniformly failed to note (i) that the failure to recapture resulted in substantial profits to the Fund's investment adviser and principal underwriter and (ii) that it was not necessary (at least prior to the abolition of "give-ups" in December 1968) for the captive broker to participate in any way in the execution of Fund portfolio transactions in order to effect recapture for the Fund's

benefit.

Preliminary Statement

This action is another in a series of lawsuits brought in this and other Circuits by mutual fund shareholders which have challenged the use - and misuse - of portfolio brokerage commissions by the managers of a mutual fund.* The pattern of conduct displayed by management in this case (viz., the application of portfolio brokerage commissions for the benefit of management rather than the fund) is symptomatic of practices which pervaded the mutual fund industry during the 1960's. Unremitting pressure by the Securities and Exchange Commission and the courts gradually eliminated many of these practices while the advent of competitive commission rates during the 1970's, accompanied

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* Although the lawsuits have been numerous, judicial decisions have been relatively sparse, many such actions having resulted in court-approved settlements. See, e.g., Kurach v. Weissman, 49 F.R.D. 304 (S.D.N.Y. 1970); Weiss v. Chalker, 59 F.R.D., 533 (S.D.N.Y. 1973). Although this Court has not previously ruled on the duty of management to recapture portfolio brokerage commissions, a panel of this Court heard argument in a matter entitled Fogel v. Chestnutt (Calendar No. 74-2582) on September 22, 1975, the decision in which may have some bearing on the issues presented in this action.

by restrictions on institutional members of registered securities exchanges, so radically altered the environment in which mutual funds operate that recapture is no longer a pressing issue. There remains, however, the question of management's liability for practices that originated in the 1960's by which millions of commission dollars which could have been recovered for the fund were instead applied by management for its own benefit.

During the 1960's mutual funds as a whole experienced an extraordinary growth in total assets. This enormous increase resulted in part from successful investment performance but also, in substantial measure, from sales of new fund shares. Regardless of the source of that growth, the increase in total assets sparked a dramatic increase in the size and frequency of portfolio transactions, which in turn resulted in the payment of substantial sums to stock brokerage firms as fees for the execution of these transactions. Under rules adopted and implemented by all securities exchanges until 1971 mutual funds were compelled to pay a fixed minimum commission to the executing broker regardless of the magnitude of the transaction or the willingness of the broker to rebate a portion of the commission to the fund. Because the minimum commission on large transactions

far exceeded the cost (including a reasonable profit) of executing the transaction, brokers were more than willing to surrender a substantial portion of the commission at the direction of the fund's manager in order to assure themselves additional business in the future.

That portion of the brokerage commission that exceeded the executing broker's cost and normal profit was sometimes referred to as "soft" dollars and constituted a form of currency that could be transferred by, and used to purchase benefits for, those who exercised control over the allocation of the commission. That control almost invariably rested with the manager of the fund, since the manager, under its contracts with the fund, typically had the power to determine where, when and how these dollars would be used. Until the SEC and the courts began to look more closely at the practices of mutual fund managers, these excess dollars were rarely used for the benefit of the fund, even though the fund's portfolio transactions had generated the commissions. Instead, fund managers allocated these transactions among executing brokers in ways that would permit the manager to utilize excess commission dollars for their own benefit.

Typical of the practices that developed was the

allocation by the manager of "reciprocals" and "give-ups".* The admitted purpose of these practices was to compensate the broker-recipients of these "soft" dollars for services (principally the sale of fund shares to new investors and the rendering of investment advice) which bore no relation to the execution of the portfolio transaction itself. Moreover, as in the present case, these services were ones which the manager was obligated under its contracts with the fund to provide at its own expense, and the allocation of "soft" dollars in this fashion utilized fund assets to discharge an obligation of the manager. In short, the use of "reciprocals" and "give-ups", techniques which were admittedly extensively employed by the defendants in this action until proscribed by regulatory action, provided a classic opportunity for self-dealing at the expense of the fund and its investors.

The extensive diversion of "soft" commission dollars for the benefit of fund managers and the selection of executing brokers for reasons unrelated to their ability to execute the particular portfolio transaction gradually attracted the attention of the SEC. In its Report on the Public Policy Implications of Investment Company Growth, H.

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* The mechanics of these practices are described at pages 22-25.

Rept. No. 2337, 89th Cong., 2d Sess. (1966) ("PPI Report"), the Commission declared (p. 172) that the use of give-ups and reciprocals to reward brokers and dealers who sold Fund shares, while beneficial to fund managers, was detrimental to the funds themselves and their shareholders.

Even before the issuance of the PPI Report some fund managers had begun to take steps to "recapture" excess commission dollars for the benefit of fund investors by (a) forming brokerage subsidiaries which joined the Pacific Coast Stock Exchange and (b) crediting the profits of the subsidiary against the advisory and service fees otherwise payable by the fund. The PPI Report approved the adoption of those techniques and suggested other possible methods of recapture. The PPI Report's condemnation of give-ups and reciprocals as benefitting fund managers to the detriment of the fund provided a strong impetus to fund managers to exhaust available methods of recapture or face the prospect of liability to the fund and its investors.

Although not all funds were in a position to recapture "soft" commission dollars - generally because neither the fund nor its manager was a member of any exchange or of the National Association of Securities Dealers, Inc. ("NASD") - recapture was freely available to those funds,

like defendant Chemical Fund, whose manager, directly or through an affiliated company, was already engaged in the brokerage business. In fact, a number of funds - through their managers or affiliates - had long been recapturing excess commission dollars arising from fund portfolio transactions by receiving some portion of the commissions earned for execution of such transactions and crediting it against the advisory fee.

In 1971, in the landmark decision of Moses v. Burgin, 445 F.2d 369 (1st Cir.), cert. den. sub. nom. Johnson v. Moses, 404 U.S. 994 (1971), the Court of Appeals for the First Circuit held that, where recapture of excess commission dollars was "freely available" to the fund, the manager had an unequivocal legal duty to apply those dollars for the benefit of the fund. 445 F. 2d at 374. The Court expressly overruled the contention of the defendants that the failure to recapture could be immunized under the "business judgment" rule, notwithstanding the finding of the trial court that "the directors believed that Fund's awards of give-ups to brokers who sold its shares to the public enhanced its sales". On appeal, the defendants had argued that "if recapture was in fact practical, the directors still had a right to choose between recapture of give-ups for

Fund's direct benefit, and awarding them to brokers for its indirect benefit" (445 F. 2d at 374). The Court's response was clear and direct:

> "We hold, however, that if recovery was freely available to Fund, the directors had no such choice." 445 F. 2d at 374.

In Moses v. Burgin the Court laid to rest the notion that excess commission dollars, which, beyond any doubt, are the property of the fund, could be diverted from the fund and used for the benefit of the manager if they were otherwise freely available to the fund.*

It is plaintiff's position that the fiduciary principles laid down in Moses v. Burgin are squarely applicable here and that the District Court erred in its narrow reading of that decision. Indeed, this case is, if anything, a much clearer case for the application of those principles. First, unlike the situation in Moses v. Burgin, a variety of recapture techniques were freely available to the Fund, because the parent of the fund manager involved has at all times been a member firm of the New York Stock Exchange

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* In addition, in Moses v. Burgin, supra, the Court held that the charter of the fund (which is almost identical in its relevant parts to the certificate of incorporation of Chemical Fund) required the fund to recapture all available brokerage commissions. 445 F. 2d at 374.

("NYSE") and the NASD. Second, although the directors of the Fund were fully aware that the failure to effect recapture permitted several million dollars in recapturable commissions to be applied for the benefit of the fund manager, they took no steps to protect the interest of the Fund's shareholders. Third, although the Fund's prospectuses (by which investors were induced to purchase Fund shares) and proxy statements (by which investors were induced to approve the advisory and underwriting contracts and elect directors) indicated that brokerage commissions were allocated to brokers for reciprocal purposes and that the Fund's broker affiliate would not be used as an executing broker, these documents never disclosed (a) that portions of these commissions were being allocated to brokers who had not participated in any way in the execution of the transaction, (b) that portions of these commissions could be recaptured for the Fund and (c) that failure to recapture permitted these commissions to be diverted from the Fund and applied for the benefit of the Fund's manager. For these reasons the judgment below should be reversed, and judgment entered for plaintiff.

Nature of the Action

This action is brought by a shareholder of

Chemical Fund, Inc. ("Fund") derivatively on behalf, in the right, and for the benefit of the Fund (A-27, ii). Plaintiff is and has been a shareholder of record of the Fund continuously since at least January 1, 1965 (A-27, i).

Plaintiff contends that by causing the Fund to forego recapture of excess commissions on portfolio transactions which were freely available to the Fund, defendants (other than the Fund) violated their fiduciary duties to the Fund, breached the Fund's management and distribution agreements and violated certain provisions of the Fund's certificate of incorporation. Plaintiff also contends that the Fund's prospectuses, proxy statements and other documents filed with the SEC contained material omissions.

The foregoing acts and practices constitute violations of the Investment Company Act of 1940 (15 U.S.C. §80a-1, et seq.), the Securities Exchange Act of 1934 (15 U.S.C. §78a, et seq.) and the Securities Act of 1933 (15 U.S.C. §77a, et seq.) and rules and regulations thereunder. The jurisdiction of this Court over the subject matter of the action is expressly conferred by each of the foregoing Acts.

Parties

A. The Fund

The Fund is a Delaware corporation and is named

herein as a nominal defendant. It is, and at all times relevant herein has been, registered under the Investment Company Act as an open end diversified investment company, otherwise known as a mutual fund. (A-28, v and viii)

B. Fund's Manager and Distributor

Since prior to January 1, 1965, defendant F. Eberstadt & Co. Managers & Distributors, Inc. ("M&D"), a Delaware corporation, has acted, pursuant to written contracts, both as manager of the Fund and as distributor of its shares. (A-28, ix) M&D has at all relevant times been a member of the NASD. (A-28,ix)

In its capacity as manager (or "investment adviser") of the Fund, defendant M&D has (a) performed various management, statistical and accounting services for the Fund, (b) provided advice and recommendations with respect to investment decisions and (c) managed and supervised the business and affairs of the Fund, subject to the Fund's Board of Directors. (A-28, ix)

Pursuant to paragraphs 2, 3 and 5 of the Management Agreement in effect in each year since January 1, 1965, M&D is, and has been, obligated to provide all research and statistical services to the Fund at its own cost. (Exh. 79)

In its role as distributor (or "principal under-

writer"), defendant M&D arranges for the sale of Fund shares to the public through non-affiliated securities dealers at a public offering price computed at the then asset value of the Fund's shares plus a sales charge (*i.e.*, a commission).

Pursuant to paragraph 6 of the Distribution Agreement in effect in each year since January 1, 1965, M&D is, and has been, obligated to pay all costs incurred in connection with sales of Fund shares. (Exh. 79)

C. Parent and Broker-Affiliate of the Fund's Manager

Defendant F. Eberstadt & Co., Inc. ("Eberstadt"), a Delaware corporation, owns all of the outstanding shares of defendant M&D. From prior to January 1, 1965, and until November 1, 1969, F. Eberstadt & Co., a partnership, owned all such shares. On November 1, 1969, defendant Eberstadt succeeded to the business and assets of the predecessor partnership. (A-29, x)

Defendant Eberstadt and the predecessor partnership were at all relevant times regularly engaged in business as a broker and dealer in the purchase and sale of securities. From prior to January 1, 1965, and until November 1, 1969, the predecessor partnership was a member firm of the NYSE and the NASD. In 1968 it became a member

firm of the American Stock Exchange ("AMEX") as well and remained a member of that exchange until November 1, 1969. Since November 1, 1969, and continuously to date, defendant Eberstadt has been a member firm of the NYSE, the AMEX and the NASD. (A-29, x)

D. Director Defendants

The individual defendants named in the complaint were at various times the directors of the Fund. (A-29, xi) Of these defendants, only Robert G. Zeller, who is Vice Chairman of Fund's Board of Directors and Vice Chairman of M&D's Board of Directors, was served with process.* (Tr. 2, 7)

The following directors and principal officers of the Fund were affiliated with M&D, the Fund's manager and distributor, and with Eberstadt, the controlling parent of M&D, during the relevant times herein (Exhs. 28-37):

	Fund	Eberstadt	M&D
F. Eberstadt (Deceased) 1965-1969	Director & Bd. Chmn.	Partner	Director
F. S. Williams 1965-1969	Director & V. Chmn.	Partner	Director & Bd. Chmn.
1970-1973	Director & Bd. Chmn.	Director & V. Chmn.	Director & Bd. Chmn.

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* On December 17, 1974, the District Court entered an order of voluntary dismissal without prejudice as to the other individual defendants. (1a)

	Fund	Eberstadt	M&D
R.C. Porter			
1965-1969	Director & President	Partner	Director & President
1970-1973	Director & President	Director & President	Director & President
A. W. Eberstadt			
1965-1969	Director & Vice Pres.	Partner	Director & Vice Pres.
1970-1972	Director & Vice Pres.	Director & Vice Pres.	Director & Vice Pres.
R. G. Zeller			
1965-1969	Director	Partner	Director & V. Chmn.of Bd.
1970-1973	Director & V. Chmn. of Bd.	Director & V. Chmn. of Bd.	V. Chmn.of Bd. Director &
J. F. Van Deventer			
1965-1969	Sr. Vice Pres.	Partner	Vice Pres.
1970-1971	Sr. Vice Pres.	Director & Vice Pres.	Director & Vice Pres.
1972-1973	Director & Sr. V.P.	Director & Vice Pres.	Director & Vice Pres.
N.J. Prestigiacomo			
1965-1969	Vice Pres. & Secretary-Treas. 1965/6	Partner	Director & Vice Pres.
1970-1973	Vice Pres.	Director & Vice Pres.	Director & Vice Pres.
David Dievler			
1969	Treas. & Ass't. Secretary	-	Treas. & Secretary
1970-1971	Treas. & Ass't. Secretary	Treas. & Secretary	Vice Pres. & Secretary

	Fund	Eberstadt	M&D
David Dievler 1972-1973	Vice Pres.	Director & Vice Pres., Treas. & Secretary	Director & Vice Pres. - Secretary

Compensation Paid to Fund's Manager-Underwriter and to Brokers

A. Management Fees Paid by the Fund to M&D

Since January 1, 1965, the Fund has employed M&D as manager pursuant to a written agreement under which M&D furnishes the Fund with various services, including research, statistical and advisory services. (A-28, ix) From January 1, 1965, through April 1, 1970, the Fund paid M&D a quarterly management fee based upon the average daily net assets of the Fund. (A-29, xii) The management fees for the years 1965 through 1969 were (A-30, xiii):

YEAR	AMOUNT
1965	$1,160,563
1966	1,268,590
1967	1,428,228
1968	1,505,231
1969	1,521,868

On March 20, 1970, and March 14, 1971, respectively, the schedule of fees to be paid to M&D was revised. (A-30, xiv and xv) The management fees for each of the years 1970

through 1973 were (A-30, xvi):

YEAR	AMOUNT
1970	$1,662,203
1971	2,247,468
1972	3,097,640
1973	3,631,470

B. Commissions Paid to M&D on Sales of Fund Shares

M&D also acts as distributor of the Fund's shares, which are offered to the public through non-affiliated dealers at a public offering price computed at the then asset value of the Fund's shares plus a commission, a portion of which is re-allowed to non-affiliated dealers. (A-28, vii) For the years 1965 through 1973, the Fund paid gross commissions to M&D, and M&D re-allowed to non-affiliated dealers, the amounts indicated below (A-33, xix):

YEAR	APPROX. COMM. PAID M&D	APPROX. COMM. RE-ALLOWED
1965	$ 1,678,000	$1,443,000
1966	2,126,000	1,677,000
1967	1,599,000	1,237,000
1968	1,441,000	1,118,000
1969	1,328,000	1,034,000
1970	2,099,000	1,620,000
1971	3,166,000	2,434,000
1972	6,365,000	4,885,000
1973	10,751,000	8,251,000

C. Commissions Paid in Connection with Portfolio Transactions

At all times since January 1, 1965, and continuously to date, the Fund has paid brokerage commissions for the execution of purchases and sales of securities on behalf of the Fund ("portfolio transactions") on the NYSE, the AMEX and certain regional securities exchanges. (A-33, xx) For the years 1965 through 1973, such brokerage commissions were (A-34, xxi):

YEAR	AMOUNT
1965	$ 339,860
1966	447,653
1967	617,787
1968	501,604
1969	472,771
1970	651,596
1971	920,767
1972	939,660
1973	1,291,735

D. Give-ups

From January 1, 1965 through December 5, 1968, brokers who executed portfolio transactions were directed by the Fund, on the instructions of M&D, to give up a portion of their commissions for executing portfolio transactions <u>to brokers and dealers who performed no services in the execution of such portfolio transactions</u>. (A-34, xxiv-xxvi;

Tr. 96-97) Such "give-ups" were directed as additional compensation to brokers and dealers for services rendered to M&D either in the sale of Fund shares or in providing M&D with statistical and research services without making any charge therefor. (A-35, xxvi) These "give-ups", in each of the years 1965 through 1968,* exceeded the amounts below indicated (A-35, xxvii):

YEAR	AMOUNT
1965	$ 81,686
1966	136,200
1967	214,600
1968	246,600

E. Reciprocals

From January 1, 1965, through July 15, 1973,** portfolio transactions were allocated by M&D to executing brokers as a reward for the sale of Fund shares. (A-34, xxiii) During that period the commissions paid by the Fund

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* As of December 5, 1968, "give-ups" were abolished by amendments to stock exchange rules. (A-35, xxvi)

** As of July 15, 1973, the NASD adopted a rule mandating that sales of fund shares not be considered a qualifying or disqualifying factor in the allocation of portfolio transactions. (A-34, xxiii)

in connection with such transactions were (A-37, xxxii):

YEAR	AMOUNT
1965	$271,910
1966	379,752
1967	510,346
1968	430,150
1969	363,036
1970	462,613
1971	*
1972	*

From January 1, 1965, to date, additional portfolio transactions were allocated by M&D to executing brokers to compensate them for research and statistical services rendered by them to M&D. The commissions paid by the Fund in connection with such transactions were (A-37, xxxiv):

YEAR	AMOUNT
1965	$40,977
1966	42,900
1967	61,000
1968	45,967
1969	46,454
1970	91,662
1971	*
1972	*

Issues Presented

Plaintiff's claims arise from defendants' failure

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* During 1971 and 1972 over 98% of the Fund's portfolio brokerage in each year was allocated as "reciprocals" to brokers who sold Fund shares or supplied statistical and research information. (A-38, xxxv and xxxvi)

in each year since January 1, 1965, to recapture hundreds of thousands of excess commission dollars which could have been recovered for the benefit of the Fund but were instead applied for the direct benefit of M&D, the Fund's manager and underwriter.

During the relevant period (January 1, 1965 to date) the Fund, investing and reinvesting the pooled assets of its shareholders, purchased and sold vast amounts of portfolio securities on national and regional securities exchanges. (A-33, xx and xxi) These transactions were typically executed on the Fund's behalf by brokers who were member firms of these exchanges, and the Fund paid these brokers commissions determined by the minimum rate schedules established by the exchanges. (A-35, xxv; Tr. 41-42) (See chart at p. 19.

So lucrative was the Fund's portfolio business to brokers who were permitted to execute these transactions, that most of them were willing to "give up" to other brokers a major portion of the commissions paid them by the Fund in order to obtain additional orders. (A-34, xxiv-xxvii; Tr. 100) Prior to December 5, 1968, at the behest of the Fund's manager, executing brokers were directed to, and did, give up substantial portions of their commissions to other brokers

who had not participated in the execution but had assisted the manager in the sale of Fund shares (A-35, xxvi and xxvii; Tr. 33, 85, 86). The cost of execution was so low in relation to the minimum commissions specified by the exchanges that brokers were routinely willing to give up as much as 70% of their commissions to non-participating brokers (Exhs. 145-157; Tr. 93, 192).

Until July 15, 1973, brokers who had (i) assisted in the sale of Fund shares or (ii) rendered research and statistical services to M&D were permitted to execute portfolio transactions themselves. (A-34, xxiii) They would frequently be allowed to keep all the Fund commissions they received as compensation for those services, despite the fact that they were prepared to give up a portion of these commissions at the direction of M&D. These commissions were referred to as "reciprocals" (A-34, xxiii), and the amounts paid to such brokers during the relevant period were substantial. (A-37, xxxii and xxxiv) (See charts at pp. 20-21.)

Until December 5, 1968, the portion of the Fund portfolio commissions paid to brokers for services other than execution could have been recaptured for the benefit of the Fund through the "give-up" mechanism. That mechanism involved little more than bookkeeping entries. If the

executing broker had not promoted sales of Fund shares or performed research or statistical services, M&D would advise the broker by telephone or by letter that a portion of the commission was to be given to another broker. (Tr. 90) The receiving broker - by definition one who had not participated in the execution (Tr. 96-97) - would be notified that he would be receiving the "give-up" as compensation from the Fund for sales or other services he had performed. (Tr. 90) In the case of reciprocals, the give-up mechanism was not employed, because the broker who had provided sales or other services and who had been selected by M&D as the executing broker for that reason would retain the full commission - partly for execution, but mostly for sales or research and statistical services. (Exhs. 145-157; Tr. 93, 192)

Prior to December 5, 1968, virtually every dollar of portfolio commissions was utilized by M&D for "give-up" or "reciprocal" purposes. (compare A-34, xxi with A-35, xxvii, and A-37, xxxii and xxxiv) By merely directing that those portions of the commissions not needed to compensate the broker for execution be "given up" to Eberstadt for the benefit of the Fund, the Fund could have recovered substantially all of the excess dollars, without any participation

by Eberstadt in the execution of the transaction.*

There can be no mistake that the ability to direct commission dollars to selected brokers in the form of give-ups and reciprocals was highly advantageous to M&D and added to M&D's own profits.**

Because M&D's advisory fee was based on a percentage of the Fund's net assets, the amount of its contractual compensation depended in large measure on the number of Fund shares that could be sold to the public. (Exhs. 11-19, 79; Tr. 133-134) The more Fund shares the public bought, the greater became the asset value of the Fund, thereby increasing the base on which M&D's advisory fee was calculated. (Tr. 133) M&D thus directly benefitted from the sale of Fund shares. (Tr. 133)

The volume of sales of Fund shares depended in large part on the efforts of dealers who assisted in these

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* After December 5, 1968, and until July 15, 1973, though executing brokers continued to be selected for "reciprocal" purposes (A-34, xxiii), the "give-up" mechanism was no longer available (A-35, xxvi). Other recapture methods, however, continued to be available and should have been utilized to recover excess commission dollars for the benefit of the Fund. See p. 30.

** At the trial the Court elicited the testimony that give-ups were used as a practical matter to compensate non-executing brokers who had "performed some service <u>for the management</u>". (Tr. 98) (Emphasis added)

sales. (Tr. 174-175) These non-affiliated dealers received a substantial portion of the total sales commission paid by the investor in connection with such sales, and M&D, as distributor, retained the balance. (See chart at p. 18, supra.) Notwithstanding the substantial compensation paid to the dealer in connection with such sales, the Fund, at the direction of the manager, paid these dealers additional compensation, at the expense of the Fund, in the form of give-ups and reciprocals. (A-35, xxvi and A-37, xxxii) It should noted that under its Distribution Agreement with the Fund, M&D was obligated to pay all the expenses relating to the promotion and sale of Fund shares. (Exh. 33; Exh. 79: Distribution Agreement, para. 6) To the extent that these expenses were paid with commission dollars belonging to the Fund, M&D was able to reduce the expenses it was contractually obligated to pay out of its own pocket in connection with such sales. It thereby breached the terms of its Distribution Agreement with the Fund.

M&D also benefited in another manner from its ability to channel give-ups and reciprocals to selected brokers. Under the terms of its Management Agreement with the Fund M&D was obligated to provide, at its own expense, research and statistical services to the Fund. (Exhs. 11-19, 33; Exh. 79: Management Agreement, paras. 2, 3 and 5)

These services could be, and to a large extent were, provided by brokers not affiliated with the Fund who also had the capability of executing portfolio transactions. (A-34, xxiii) They were compensated for these research and statistical services with excess commission dollars that belonged to the Fund and could have been recaptured for the benefit of the Fund. By paying these excess dollars to the broker in the form of give-ups and reciprocals, M&D, in breach of the terms of the management agreement, discharged its obligation to provide research and statistical services to the Fund, paying for such services with the Fund's rather than its own, assets.

We respectfully submit, for the reasons set forth below, that (a) defendants had an unequivocal legal duty as fiduciaries to cause excess commission dollars to be recaptured for the benefit of the Fund rather than be applied for their own benefit and (b) retention of their illicit profits cannot be justified on the basis of an alleged good faith business judgment. We further submit that, even if defendants' course of conduct might otherwise be justified on the basis of "business judgment", their failure to disclose material facts concerning the Fund's ability to recapture in documents filed with the SEC and distributed to Fund investors renders them liable to the Fund for such profits.

Argument

I. BY CAUSING THE FUND TO FOREGO RECAPTURE OF EXCESS COMMISSION DOLLARS WHICH WERE FREELY AVAILABLE TO THE FUND, DEFENDANTS BREACHED THEIR FIDUCIARY DUTY TO THE FUND, BREACHED THE FUND'S MANAGEMENT AND DISTRIBUTION AGREEMENTS WITH M&D, AND VIOLATED PROVISIONS OF THE FUND'S CERTIFICATE OF INCORPORATION.

A. Recapture of commissions was freely available to the Fund.

Unlike the fact situation presented in Moses v. Burgin and in Fogel v. Chestnutt*, there is no dispute that recapture of excess commissions paid by the Fund on its portfolio business, at least prior to December 5, 1968, was at all times freely available for the benefit of the Fund.

It has been stipulated that Eberstadt, parent of the Fund's manager, M&D, has since January 1, 1965, been a bona fide member of the NYSE, the AMEX (since 1968) and the NASD. (A-29, x) By reason of these memberships the Fund at all relevant times could have recaptured commissions through a variety of recognized, lawful and accepted techniques.

It has also been stipulated in this action as follows:

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* An appeal from a judgment of dismissal in that action was argued before a panel of this Court on September 22, 1975 (Cal. No. 74-2582).

(1) While the constitution and rules of the NYSE, the AMEX and regional securities exchanges have always prohibited the rebate of commissions to customers, the NYSE, the AMEX and certain of the regional exchanges have always permitted member firms who serve as investment advisers to credit against the investment advisory fee some portion of the commissions earned by the member firm for the execution of portfolio transactions for the investment advisory client. (A-36, xxix)

(2) Since January 1, 1965, to date the Constitution and Rules of the NYSE, the AMEX and the regional exchanges would have permitted M&D to credit against the management fee payable to it by the Fund some portion of any brokerage commissions earned by Eberstadt in the execution of the Fund's portfolio transactions. (A-36, xxx)

(3) Since prior to January 1, 1965, and until December 5, 1968, the Constitution and Rules of the NYSE permitted Eberstadt to receive give-ups from other member firms of the NYSE who executed portfolio transactions for the Fund and to credit give-ups so received against the management fee payable to M&D by the Fund. (A-36, xxx)

(4) Approximately 80% of all Fund portfolio transactions executed on an exchange were executed on the NYSE. (A-33, xx)

It is not disputed that (a) defendants were aware of the rules of the various exchanges, (b) they knew, or had reason to know, that excess commissions could be returned to the fund without violating the rules of these exchanges and (c) at least prior to December 5, 1968, recapture did not require any participation by Eberstadt in the execution of portfolio transactions. During that period, therefore, excess commissions were "freely available" within the

meaning of <u>Moses v. Burgin</u> and should have been recaptured.

After December 5, 1968, a variety of recapture techniques were still available, though participation in some way by Eberstadt or M&D in the execution of the portfolio transaction would have been necessary. For example, both before and after December 5, 1968, recapture could have been effected on certain regional exchanges by Eberstadt and M&D, both of whom were NASD members. (A-28, ix and x) Even if neither wished to become a member of those exchanges, under the rules of these exchanges, as members of the NASD, they qualified for give-ups (prior to December 5, 1968) and for a reduced rate of commissions thereafter (so-called "preferred rate non-membership"). (Tr. 206-207) If Eberstadt or M&D had been permitted to participate in these portfolio transactions, their profits could have been applied, in whole or in part, as a credit against the management fee being paid to M&D. (A-36, xxix, xxx) Although recapture after December 5, 1968, would have required some involvement by Eberstadt and M&D, excess commissions could have been recaptured during that period.

B. <u>By failing to effect recapture, defendants breached their fiduciary duty to the Fund</u>.

In support of her position plaintiff relies on the principle enunciated by the First Circuit in <u>Moses v. Burgin</u>,

supra, that defendants, as fiduciaries, have an unequivocal legal duty to recapture for the Fund commissions which are and were "freely available."

During the "give-up" period, i.e., prior to December 5, 1968, commissions paid as "give-ups" and substantial portions of the commissions paid as "reciprocals" were freely available to the Fund without any participation whatsoever by Eberstadt or M&D in the execution of Fund portfolio transactions.

After December 5, 1968, a variety of recapture techniques were still available, though participation in some way by Eberstadt or M&D would have been necessary. Defendants' liability during this latter period is predicated on their unlawful use of the Fund's assets to discharge M&D's contractual obligations to the Fund under the Management and Distribution Agreements.

1. The District Court misread and misapplied Moses v. Burgin.

Although the material facts underlying plaintiff's claim were largely undisputed, the District Court dismissed the complaint after trial. The court pointed out that the Moses v. Burgin formulation had not been adopted in this Circuit and, noting that the SEC had "fully retreated from its proposed Rule 10b-10 and at least in part from its

unqualified position in the PPI report that 'give-ups' be directed to reduction of advisory fees" (A-64), concluded that "non-disclosure is the only precedential value that Burgin now retains". (A-65; A-75) Since the unaffiliated directors, according to the trial court, were kept fully advised of the possibility of recapture (A-66 thru 72), defendants had not violated the Investment Company Act or the common law.

We agree with the court below that this Court has not previously addressed itself to the fiduciary principle articulated by the First Circuit in Moses v. Burgin.* On the other hand, contrary to the conclusion of District Court, we find nothing to suggest that either the courts or the SEC have retreated one inch from the proposition that the managers of a mutual fund may not apply the property of the fund for their own benefit rather than the benefit of the

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* We do not concur, however, with the court's statement that in Fogel v. Chestnutt, 383 F. Supp. 914 (S.D.N.Y. 1974), Judge Wyatt found the Burgin decision "unpersuasive". On the contrary, Judge Wyatt adopted without question the proposition urged by plaintiff in this case: "The principle is accepted that defendants were under a duty by all proper means to secure for Fund the return of excess brokerage commissions." 383 F. Supp. at 920.

fund's shareholders.

The court below made much of the fact that in Burgin the Court of Appeals focused extensively on the fact that the fund manager had not disclosed the possibility of recapture to the fund's unaffiliated directors. In Burgin, however, the fund manager (Crosby) defended the action on the ground, among others, that recapture was not "freely available" to the fund since there was considerable uncertainty that there was any lawful means of effecting recapture. Crosby, though an NASD member, was not a member of any exchange, and it was not clear that recapture was possible at all unless the broker-affiliate of the fund became an exchange member. Following commencement of the Burgin action in December 1967, however, Crosby received concrete information from several exchanges that recapture via a non-member broker-affiliate was permissible so long as the affiliate was an NASD member. 445 F. 2d 379-381. Even though there was room for bona fide doubt prior to 1968 as to whether or not recapture was "freely available", the Court held Crosby and the other management defendants liable to the fund on the ground that they had failed to disclose to the fund's unaffiliated directors that recapture was a possibility. In contrast to Burgin, no doubt concerning the availability of recapture could, or did, exist in this case, since recapture

has at all times been freely available to the Fund.

2. The SEC has not retreated from its position on recapture.

The District Court erred not only in its narrow reading of the Burgin decision but also in its conclusion that the fiduciary principle articulated in that decision no longer has vitality. (The court did not address itself to the fact that the events in this case overlap chronologically those in Burgin.) Citing "developments since Burgin" (A-65, A-78, A-80 ff.), the District Court asserted - without justification, we submit - that the SEC has retreated from its previously stated position that a mutual fund manager has a fiduciary obligation to recapture commissions, if at all possible, for the benefit of the fund. (A-64)

"Give-ups" and "reciprocals" were symptoms of the artificially high levels of commissions on stock transactions which resulted from the fixed minimum commission rate structure that prevailed for over a century on the nation's securities exchanges. The development of the SEC's position on recapture is inextricably intertwined with the evolution of its policy toward fixed commissions.

A portion of the relevant history is spelled out in Independent Broker-Dealer T. Ass'n. v. SEC, 442 F. 2d 132, 135-136 (D.C. Cir. 1971).

The Court capsulized in its opinion the nature of the SEC's concern:

> "Give-ups, among other practices, posed problems of conflict of interest if not outright violation of fiduciary duty by managers of mutual funds. Give-ups also highlighted a serious question of whether a rigid minimum rate structure, such as the NYSE's could be considered reasonable, if brokers were willing to surrender a large part of their commissions." 442 F. 2d at 135.

On July 18, 1966, the Commission wrote to all national securities exchanges and the NASD expressing its concern over the give-up problem. In the PPI Report, the Commission spelled out at length its concern that give-ups were being used in ways that were detrimental to the interests of fund shareholders and recommended that the exchanges abolish give-ups.*

The first significant response to the SEC's recommendation was a letter dated January 2, 1968, from Robert W. Haack, then president of the NYSE, to NYSE members. The letter recommended, among other things, the institution of volume discounts in the commission rate schedule but retention of customer-directed give-ups. The letter further stated that these proposals had been submitted to the SEC for its consideration. 442 F. 2d at 136.

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* H.R. Rep. No. 2337, 89th Cong., 2d Sess. 172, 185-186 (1966).

On January 26, 1968, the Commission issued its Release No. 8239, which (a) announced the submission of the NYSE proposals and (b) stated that it had under consideration the adoption of proposed Rule 10b-10 under the Securities Exchange Act of 1934.* The release contains an extensive discussion of the relationship of give-ups and related brokerage practices to the minimum commission rate structure on the exchanges and spells out the SEC's concern that, while these practices had substantially reduced the amount of commissions retained by executing brokers, they had had relatively little impact or effect on the commissions actually paid by public investors who invest in securities through mutual funds and other institutional media. In contrast to the NYSE proposals, which would have permitted the continuation of give-ups, the Commission proposed the adoption of Rule 10b-10, which would have prohibited give-ups and related practices unless the benefits derived from these practices accrued to the Fund's shareholders.

> "The reasoning on which the proposed rule is based is that <u>if, as pointed out above, a mutual fund manager has various means at his disposal to recapture for the</u>

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* Sec. Exch. Act Release No. 8239 (Jan. 26, 1968) (Exh. 89); (1967-1969 Transfer Binder) CCH Fed. Sec. L. Rep. ¶77, 523. The release contains the full text of the Haack letter of January 2, 1968.

benefit of the fund a portion of the commissions paid by the fund, he is under a fiduciary duty to do so. Furthermore, diversion of such commissions to benefit an investment company manager may be viewed as additional compensation to the manager for handling the portfolio transactions of the fund within the meaning of, and in violation of Section 17(e) (1) of the Investment Company Act.

"The proposed rule therefore reflects a duty on the part of mutual fund managers and fiduciaries not to use commissions paid by their beneficiaries for the benefit of the fiduciary when practices, procedures, and rules of the markets in which such fiduciaries act permit their beneficiaries to receive tangible benefits in the form of reduction of the charges now borne by them. The proposed rule is bottomed on the premise that when a fiduciary uses commissions to obtain benefits for himself under these circumstances, his conduct would appear to violate applicable antifraud provisions of the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 as well as Section 17(e) of the Investment Company Act, particularly in view of the obscure and often devious ways in which this is accomplished. The proposed rule would be adopted pursuant to Sections 10(b) and 15(c) (1) and (2) of the Securities Exchange Act of 1934, Sections 206 (4) and 211(a) of the Investment Advisers Act of 1940 and Sections 17(e) and 38(a) of the Investment Company Act." (Emphasis added.)

On May 28, 1968, following receipt of comments on the NYSE and SEC proposals, the Commission issued an order directing a public hearing and investigation on several subjects, including "give-ups and reciprocal practices among different categories of members and non-members." 442 F. 2d at 136. Negotiations then ensued between the NYSE and the

SEC which resulted in a reduction in the NYSE's minimum commission rate schedule and the abolition of all customer - directed give-ups.* 442 F. 2d at 136.

The SEC continued to adhere to its position on recapture through the early 1970's. In Matter of Provident Management Corp., CCH Fed. Sec. L. Rep. (1970-1971 Transfer Binder)¶77,937 (1970), the Commission applied the reasoning of proposed Rule 10b-10 in a litigated matter and held that the obtaining of benefits by the fund manager for itself from the allocation of portfolio brokerage constituted, among other things, a violation of the antifraud provisions of the Securities Exchange Act and Section 17(e)(1) of the Investment Act. In August 1971, the Commission filed an amicus brief in Gross v. Moses 67 Civ. 4186 (S.D.N.Y.) in which it supported recapture.

Following the Burgin decision in June 1971, which placed a judicial imprimatur on the SEC's oft-stated view that a fund manager cannot utilize excess commissions for

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* It is noteworthy that proposed Rule 10b-10 would not have abolished all customer-directed give-ups but only those not recovered for the benefit of fund investors. See Mutual Funds and Independent Directors: Can Moses Lead to Better Business Judgment? 1972 Duke L.J. 429, 447 (fn. 127).

its own benefit, the SEC began to turn its attention more forcefully to the cause rather than the symptom, of "give-ups" and "reciprocals", namely, the high level of brokerage commissions resulting from an absence of competition. Thereafter, in a series of steps that commenced with the introduction of negotiated rates on large transactions in 1971 and culminated with the elimination of minimum commissions in May of this year, the SEC has gradually brought about price competition in the securities industry. See Sec. Exch. Act Release No. 11, 203 (January 23, 1975); 1975 CCH Fed. Sec. L. Rep. ¶80, 067. By compelling a reduction in portfolio commissions to a fair and reasonable level, the SEC has substantially lowered the cost of portfolio brokerage to the fund and brought about a form of automatic recapture. Thus, contrary to the conclusion of the court below, the SEC has not "retreated" from its position on recapture, instead it has eliminated the peculiar circumstance (viz., excessively high commissions on portfolio transactions) that made recapture a necessary practice to protect the interest of fund shareholders.

3. Defendants' failure to recapture constituted flagrant self-dealing.

Although the District Court acknowledged that the opportunity for self-dealing by the defendants was great

(A-76) and adverted to plaintiff's contention that defendants were using Fund assets for their own benefit (A-78), the District Court then proceeded to conclude that any self-dealing was unassailable under the securities laws because there had been full disclosure to the unaffiliated directors and to the shareholders. In that conclusion the District Court erred, even assuming full disclosure.*

In its opinion the trial court laid strong emphasis on the philosophy of full disclosure underlying the federal securities laws. In doing so, however, the court overlooked the fact that a dominant purpose of the Investment Company Act, in contrast to the Securities Act and the Securities Exchange Act, was to impose high standards of fiduciary conduct not only on officers and directors of mutual funds but also on their investment advisers and principal underwriters. In holding that "...a requirement of full disclosure and lack of misrepresentation encapsulates the impact of the federal securities laws," the District Court simply cast into oblivion the provisions of the Investment Company Act and the substantial body of decisional law that make it unlawful for the managers of a fund to use the shareholders' property for

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* In fact, the disclosure to the shareholders fell far short of the requirements of the federal securities laws. See Point II, infra.

their own benefit.

Section 36 of the Investment Company Act, 15 U.S.C. §80a-35, prior to its December 14, 1970 amendment, authorized recovery in a private action for acts of "gross misconduct or gross abuse of trust" on the part of officers, directors or investment advisers of registered investment companies. Moses v. Burgin, 445 F. 2d 369, 373 (1st Cir. 1971); cert. den. sub. nom. Johnson v. Moses, 404 U.S. 994; Brown v. Bullock, 194 F. Supp. 207, 245 (S.D.N.Y. 1961), aff'd., 294 F. 2d 415 (2d Cir. 1961); Tanzer v. Huffines, 314 F. Supp. 189 (D. Del. 1970).

Section 1(b)(2) of the Act, 15 U.S.C. §80a-1(b)(2), requires, as a matter of federal law, that the officers, directors and investment adviser of an investment company manage it solely in the interest of the shareholders, to the exclusion of their own interests. As stated in Aldred Inv. Trust. v. SEC, 151 F. 2d 254, 260 (1st Cir. 1945), cert. den., 326 U.S. 795:

> "Section 1(b) of the Act, 15 U.S.C.A. 80a-1(b), in effect codifies the fiduciary obligations placed upon officers and directors of investment companies."

And in Brown v. Bullock, 194 F. Supp. 207, 234 (S.D.N.Y. 1961), aff'd 294 F. 2d 415 (sd Cir. 1961), the Court said:

> "The Act, section 1(b)(2), explicitly declares that one of its purposes is to

protect investors against the operation of investment companies in the interest of directors, officers or investment advisers rather than in the interest of stockholders. Such directors, officers and investment advisers are under the fiduciary duty to manage the companies entrusted to their care with a single eye to their best interest, free from any self-dealing. That is the pervasive policy of the Act.

* * * * *

"Regardless of their foundation in the common law, these fiduciary obligations are granted a federal basis resting in the Act, ..." (Emphasis added.)

In 1970, Congress strengthened the protections afforded mutual fund investors under the Investment Company Act by amending §36 in certain respects, designating old §36 as §36(a), and adding a new subsection, §36(b). Section 36(a) became effective December 14, 1970, the date of enactment; §36(b) became effective June 14, 1972, 18 months thereafter.

Under the 1970 amendments the phrase "gross misconduct or gross abuse of trust" contained in old §36 was deleted, and "breach of fiduciary duty involving personal misconduct", a stricter standard of fiduciary responsibility,

was substituted in its stead.* In addition, §36, as amended, expressly refers to and incorporates in §36(a) the broad policy statements and fiduciary standards implied in §1(b).**

Defendant's failure to recapture presents a classic case of self-dealing at the expense of the Fund which constitutes a breach of fiduciary under §§36 and 1(b) of the Investment Company Act, both before and after December 14, 1970.

M&D is, and at all times has been, the investment adviser of the Fund as well as its principal underwriter. It acts in those capacities under terms which are spelled

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* The committee reports in both houses of Congress (using identical language) make it clear that "personal misconduct" was not intended to require that there be either an actual intent to violate the law or acts of affirmative misconduct.

> "In appropriate cases, nonfeasance of duty or abdication of responsibility would constitute a breach of fiduciary duty involving personal misconduct." Report of the Committee on Banking and Currency, Senate Report No. 91-184 (1969), p. 36; Report of the Committee on Interstate and Foreign Commerce, House Report No. 91-1382 (1970), p. 37; CCH Fed. Sec. L. Rep. ¶49, 791.09.

** Section 36(b) imposes a fiduciary duty on the investment adviser of a fund with respect to compensation or other payments. At least one district court has held that failure to recapture commissions would under some circumstances be remediable under that subsection. See Frankel v. Hyde, CCH Fed. Sec. L. Rep. ¶94, 486 (S.D.N.Y. 1974).

out in the Management Agreement and Distribution Agreement, respectively (Exh. 79), each of which is required by law to be approved annually by the shareholders of the Fund or its board of directors. Under the Management Agreement M&D obligated itself, among other things, to manage the Fund's affairs and to provide the Fund with investment advice and recommendations. Under the Distribution Agreement M&D agreed, among other things, to promote the sale of Fund shares through a dealer network. The Fund paid M&D generously for its services. In each year since 1965 M&D has received well over one million dollars under each contract.

As the District Court recognized (A-76), a mutual fund is essentially a shell. Office space, staff and management services are provided by the investment adviser. The underwriter assumes full responsibility for sales of the fund's shares. In the typical case, adviser and underwriter agree, as part of the consideration under the management and distribution agreements, to pay all costs and expenses incurred in performing the investment advisory and distribution functions. That was the case here. Under paragraphs 2, 3 and 5 of the Management Agreement (Exh. 79) M&D agreed to furnish the Fund, at its own expense, all research and statistical, as well as management, services. Under para-

graph 6 of the Distribution Agreement (Exh. 79) M&D expressly agreed to pay all its own costs and expenses and all costs and expenses of the Fund in connection with sales of Fund shares.

The direct cost to M&D of performing the investment advisory and distribution functions was high. The record shows that the net operating expenses of M&D rose from over one million dollars in 1966 to over $2.1 million in 1972 (Exhs. 93-97; Exh. A). During these same years, however, M&D also incurred substantial additional operating expenses which it did not pay directly - indeed, M&D did not pay them at all! The record shows that M&D allocated "give-ups" and "reciprocals" to stockbrokers as compensation for selling Fund shares or providing research and statistical services in amounts ranging from a low of approximately $400,000 in 1965 to about $1.25 million in 1973 (see pp. 19-21, supra). In other words, a substantial portion of M&D's total operating expenses were paid each year by the use of "give-ups" and "reciprocals", which represented assets of the Fund and which could have been recaptured for the benefit of the Fund's shareholders. Instead, in direct violation of the provisions of the Fund's management and distribution agreements defendants caused a substantial portion of M&D's

expenses to be borne by the Fund.

The use of Fund assets to discharge the contractual obligations of M&D constituted a breach of fiduciary duty under §§36 and 1(b) of the Investment Company Act. Moses v. Burgin, 445 F. 2d 369, 373 (1st Cir. 1971); Fogel v. Chestnutt, 383 F. Supp. 914, 920 (S.D.N.Y. 1974) ("The principle is accepted that defendants were under a duty by all proper means to secure for Fund the return of excess brokerage commissions.")

Defendants' use of recapturable commissions to pay M&D's expenses also violates other provisions of the federal securities laws. An analogous situation was presented in Matter of Provident Management Corp., CCH Fed. Sec. L. Rep (1970-1971 Transfer Binder) ¶77,937 (SEC 1970). In that case the management defendants had, among other things, directed portfolio brokerage to a broker who in turn furnished sales brochures, sales lectures and other selling aids without charge to Pennsylvania, an affiliate of the adviser. CCH ¶77,937 at p. 80,088. The Commission held:

"The effect of this arrangement was to use Fund brokerage to pay Pennsylvania's selling expenses. . . For reasons previously stated, we find that by causing Pennsylvania to receive additional compensation in return for the allocation of Fund brokerage, [the management defendants] willfully violated and willfully aided and abetted in the violation of Section 17(e)(1) of the Investment Company Act as well as Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 206 of the Advisers Act."* CCH ¶77,937 at p. 80,088.

Moreover, in addition to their liability under the federal securities laws, defendants, by diverting Fund assets to discharge contractual obligations to M&D, are liable to the Fund and its shareholders for breach of fiduciary duty at common law. Cf. Lutz v. Boas, 171 A. 2d 381 (Del. Ch. 1961); Acampora v. Birkland, 220 F. Supp. (D. Colo. 1963).

C. The use of excess commissions to compensate dealers who sold Fund shares violated the Fund's certificate of incorporation.

Defendants' use of recapturable commissions to compensate dealers who sold Fund shares not only breached M&D's express contractual obligation to pay all costs and expenses in connection with sales of Fund shares, it also violated

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* The Commission also held that the failure to disclose the arrangement in the annual reports of the fund filed with the Commission on Form N-1R and in the proxy material sent to the fund's shareholders constituted violations of the disclosure provisions of the 1933 Act, the 1934 Act and the 1940 Act. CCH ¶77,937 at p. 80,089.

the express provision of the Fund's certificate of incorporation that requires the Fund to receive not less than "net asset value" for each share sold.

Article Eighth, Section B 5(b) of the Fund's charter has at all times provided as follows:

> "[T]he Board of Directors shall have power . . . to authorize the issue of sales of shares . . . from time to time . . . for a consideration, per share, to the [Fund] not less than the asset value, per share, of the outstanding shares of the [Fund]." (A-31, xviii)

That provision of the charter by its terms precludes the Fund from receiving less than "net asset value" in connection with sales of Fund shares. It is clear beyond any doubt, however, that to the extent that the defendants caused give-ups and reciprocals to be paid as additional compensation to dealers who sold Fund shares, the net price received by the Fund was something less than "net asset value". Accordingly, the deliberate use of recapturable commission dollars for that purpose represents a violation of the Fund's certificate of incorporation and is ultra vires, whether or not it also constitutes a breach of fiduciary duty.

In <u>Moses v. Burgin</u>, <u>supra</u>, the Fund's charter contained a similar provision relating to the sales price of Fund shares, which read as follows:

> "In no event shall any shares of Capital

Stock of the corporation be issued or sold for a consideration (which shall be net to the corporation after underwriting discounts or commissions) less in amount or value than the net asset value of the shares so issued or sold, . . . "

The Court of Appeals held that give-ups paid as additional compensation to selling brokers were, as a matter of law, recoverable by the fund:

> "If [F]und receives the asset value of any shares, but at the same time rewards the selling broker with give-ups that it has a right to recapture for itself, then the net income [F]und receives from the process of selling a share is less than asset value. The existing shareholders have contributed -- by paying more than otherwise necessary on the fund's portfolio transactions -- to the cost of the sale [if any], which was supposed to have been borne by the new member alone." 445 F. 2d 369,374.

The Court of Appeals' analysis in Moses v. Burgin is directly applicable here. The record shows that dealers who sold Fund shares received not only the underwriting discounts and commission which were built into the offering price of the shares sold to new investors, but also additional compensation in the form of give-ups and reciprocals paid by the Fund itself. (A-34, xxiii; A-35, xxvi; A-37, xxxii; A-38, xxxv and xxxvi; Tr. 202) It is axiomatic, therefore, that the net amount received by the Fund after allowing for payment of this additional compensation was something less than

"net asset value". Since any payment by the Fund to selling brokers which reduced the amount received by the Fund below "net asset value" violated the Fund's certificate of incorporation, defendants are liable to the Fund for all such payments.

II. DEFENDANTS VIOLATED THE DISCLOSURE PROVISIONS OF THE FEDERAL SECURITIES LAWS.

In its opinion (A-72) the District Court duly noted plaintiff's contention that the Fund's proxy statements* (Exhs. 28-37), annual and quarterly reports (Exhs. 39-54; 88, 125-127) and prospectuses (Exhs. 11-19; N) were materially false and misleading in that they failed to disclose that:

> (a) "give-ups" and "reciprocals" were being used to discharge contractual obligations which M&D owed to the Fund under the management and distribution agreements;
>
> (b) the Fund was receiving less than net asset value, because recapturable brokerage commissions were being used as added compensation to dealers who sold Fund shares; and
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> (c) prior to December 5, 1968, "give-ups" were paid to brokers who had not participated in any way in the execution of portfolio transactions.

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* Footnote 2 on page 20 of the Court's opinion (A-71) is in error. The documents marked as Exhibits 28-37 are the Fund's Notice of Annual Meeting of Shareholders and Proxy Statement for each of the years 1965-1974.

The Court did not squarely hold, however, either that these matters had been disclosed to Fund shareholders or that they had not been disclosed. Instead, after reciting plaintiff's contentions, the Court merely stated:

> (1) "the unaffiliated directors were advised and kept fully abreast of their power if they wished to change existing policy, and of the SEC views and proposals on the issues" (A-72); and
>
> (2) "while the full implications of the policy were not spelled out, the policy was announced to the shareholders in every prospectus issued since 1965" (A-73).

For the reasons set forth below, we respectfully submit that the District Court erred in failing to hold that defendants had violated the disclosure provisions of the Securities Act, the Securities Exchange Act and the Investment Company Act.

First, the mere fact that the management defendants may have made full disclosure to the unaffiliated directors is of no relevance in determining whether or not they made adequate disclosure of the material facts in documents distributed to Fund shareholders. As purchasers of Fund securities, Fund shareholders were entitled to full disclosure of every material fact bearing on their investment. As voting stockholders, they were entitled to be informed of every material fact germane to the election of directors and any other matters presented for shareholder approval. In each case, we submit, the shareholders were entitled to know

(1) that the excess commissions being paid to brokers as "give-ups" and "reciprocals" represented assets of the Fund that could readily be recaptured for the Fund's benefit; (2) that the fees paid to M&D as manager and underwriter were being augmented, in violation of the Management and Distribution Agreements, by the use of Fund assets in the form of recapturable commissions; (3) that the Fund was receiving less than net asset value for each share sold, because the Fund was paying dealers additional compensation out of Fund assets in the form of recapturable commissions; and (4) that (prior to December 5, 1968) brokers who had not participated in any way in the execution of portfolio transactions were being given a portion of the commissions on those transactions by way of "give-ups" as compensation for services rendered on behalf of M&D. See Matter of Provident Management Corp., supra, CCH ¶77,937 at p. 80,089.

While disclosure of the foregoing information would have been pertinent in the Fund's prospectuses and annual reports because such information would have revealed that assets of the Fund were being diverted for the benefit of the Fund's manager and underwriter, disclosure in the proxy materials was even more critical. Assuming, as the District Court held, that the possibility of recapture had been fully disclosed to the Fund directors but they had decided as a

matter of business judgment to do nothing, the Fund's shareholders, in voting to elect directors, were entitled to know the full implications of the incumbents' policy. How could these shareholders make an informed judgment on the wisdom of that policy unless they were fully advised that: (a) recapture was an available and proper course of action for the Fund to pursue, (b) recapture would have meant an increase of hundreds of thousands of dollars in the Fund's assets without any impact whatever on the execution of portfolio transactions, and (c) failure to recapture meant that M&D was able to shift a part of the cost of managing the Fund and distributing its shares back to the Fund itself. As voting shareholders, it was their prerogative to determine whether or not the non-recapture policy, which worked to the material detriment of the Fund, should be permitted to continue. In short, the mere fact that some, or all, of the relevant facts were disclosed to the unaffiliated directors is no answer to plaintiff's claim that these facts should have been fully disclosed to the shareholders.

We turn next to the other ground relied upon by the District Court in rejecting plaintiff's claim of nondisclosure. The Court stated that, during the relevant period, the shareholders were "informed of the Fund's policy of brokerage allocations and of not utilizing

Eberstadt in this connection" and that "the policy was announced to the shareholders in every prospectus issued since 1975". (A-73) The Court went on to observe, however, that "the full implications of the policy were not spelled out". (A-73)

In light of the Court's observation that "the full implications of the policy were not spelled out", we do not see how the District Court could have concluded that defendants met the standard of full disclosure mandated under Section 17(a) of the Securities Act, 15 U.S.C. §§77q; Sections 10(b) and 14(a) of the Securities Exchange Act, 15 U.S.C. §§78j and 78n, and Rules 10b-5 and 14a-9 thereunder; and Section 80(a) of the Investment Company Act, 15 U.S.C. § 80-20(a), and Rule 20a-1(a) thereunder. Under those statutes and rules it is unlawful for the person making the disclosure not only to make an untrue statement of a material fact but also to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. Mere statement of the Fund's "policy", as the District Court described it, is legally insufficient under those statutes and rules if defendants failed to disclose material facts concerning the policy and its implications for the Fund, and the result was to deprive Fund shareholders of the facts needed to make an informed judgment. Mills v. Electric Auto-Lite Co., 396 U.S.

375 (1970), Schlick v. Penn-Dixie Cement Corp., 507 F. 2d 374 (1974).

As the District Court noted (A-73), the Fund's prospectuses, through 1972, informed shareholders that, subject to best execution, the Fund's brokerage business was allocated among brokers based on sales of Fund shares and services rendered to the Fund. The prospectuses also stated that the Fund did not intend to use Eberstadt as an executing broker. Similar statements are contained in the Fund's proxy statements (Exhs. 28-37). None of these documents, however, sets forth any information upon which the shareholders could have ascertained the real implications of the portfolio policy of the Fund so far as their own interests were concerned. None of these documents contained any information concerning (1) the availability of recapture for the benefit of the Fund, (2) the potential benefits to the Fund of recapture, (3) the absence of any need, at least prior to December 5, 1968, to involve Eberstadt or M&D in portfolio transactions for the Fund in order to effect recapture or (4) the adverse effect on M&D (and Eberstadt) if commissions were recaptured for the Fund's benefit rather than allocated in ways that benefited M&D. Without such information, a reasonable shareholder would be led to believe

that the Fund's interests were affected neither favorably nor unfavorably by the Fund's existing policy. Moreover, the statement found in these documents that the Fund did not intend to use Eberstadt as an executing broker undoubtedly had the effect of portraying Eberstadt as selflessly eschewing any thought of gain at the expense of the Fund. In fact, as we have shown, the Fund's portfolio policy and the refusal to use Eberstadt as an executing broker resulted in substantial benefits to Eberstadt through its wholly-owned subsidiary, M&D.

In Matter of Cornfeld, CCH Fed. Sec. L. Rep. (1970-1971 Transfer Binder) Para. 77,963 (S.E.C. 1971), the Commission, in an analogous situation, held that the failure to disclose (a) the interest of a fund's principal underwriter in the allocation of fund portfolio transactions and (b) the fact that the commissions involved could have been recaptured for the fund violated the federal securities laws.

> "Among other things, for the purpose of securing benefits for themselves and persons other than the Fund and its shareholders, respondents caused the Fund to allocate portions of its brokerage to certain persons pursuant to an arrangement whereby its principal underwriter received a portion of the commissions earned by such other persons; and respondents failed to disclose to the Fund and its shareholders and caused the sale of Fund shares through the use of misleading prospectuses which failed to disclose that respondents had interests adverse

> to the Fund and its shareholders in the allocation and consummation of the Fund's portfolio transactions, and that the compensation received by respondents as a result of the activities described above could have been returned to the Fund." CCH Para. 77,963 at P. 80,136-137.

The Commission held that the foregoing conduct violated, among other things, the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act, and Section 34 of the Investment Company Act. The Commission also found that respondents had violated Section 20(a) of the Investment Company Act and Rule 20a-1 thereunder,

> " . . . in that they solicited proxies without furnishing the persons solicited information related to the practices and course of business involving the allocation of portions of the Fund's brokerage described above." CCH Para. 77,963 at p. 80,137.

Although the Cornfeld decision apparently involved non-disclosure to the fund as well as to its shareholders, the principles enunciated by the Commission are equally applicable here. Where the management of a fund has interests adverse to the Fund and its shareholders in the allocation of portfolio brokerage and recapture for the benefit of the fund is practicable, disclosure of these facts must be made to shareholders in fund prospectuses and proxy statements and to the SEC in required filings.

The failure of defendants to disclose in the Fund's proxy statements material facts regarding recapture consti-

tutes a violation of Sec. 14(a) of the Securities Exchange Act, 15, U.S.C. Sec. 78n(a), and Rule 14a-9 thereunder, 17 C.F.R. Sec. 240.14a-9. It is established law that a private claim can be based on a violation of the proxy rules promulgated under Sec. 14(a). J.I. Case v. Borak, Inc., 377 U.S. 426 (1964). By the terms of Sec. 20(a) of the Investment Company Act, 15 U.S.C. Sec. 80a-20(a), and Rule 20a-1(a), 17 C.F.R. Sec. 270.20a-1, any violation of Sec. 14(a) of the Exchange Act is a violation of Sec. 20(a). See Monheit v. Carter, 376 F. Supp. 334, 339-340. Accordingly, plaintiff is entitled to recover all damages resulting from such misrepresentations and omissions and is entitled to appropriate injunctive relief.*

III. "BUSINESS JUDGMENT" IS NOT A DEFENSE TO PLAINTIFF'S CLAIMS

In dismissing the complaint, the District Court concluded that the Board had exercised a good faith business judgment in determining not to recapture and that, having relied on the advice of counsel, it was free of all liability (A-79). The pertinent portion of the Court's opinion reads as follows:

> "What is involved here is the exercise of a good faith business judgment. On the facts developed before me, I have no basis for finding that the Board failed to exercise such care

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* The same misrepresentations and omissions are also found in the registration statements and prospectuses utilized by the Fund in connection with the sales of Fund shares to public investors and would, therefore, constitute violations of Secs. 11, 12 and 17 of the Securities Act of 1933, 15 U.S.C. Secs. 77k, 77l and 77q and Section 10(b) of the

> and diligence in respect of the matters in controversy that careful and prudent men could reasonably be expected to exercise under similar circumstances. See Ballantine on Corporations, Sec. 63 (Rev. Ed. (1946). When questions arose the Board sought and relied upon the advice of counsel which alone is sufficient to free them of liability. See Spirt v. Bechtel, 232 F. 2d 241, 247 (2d Cir. 1956). Nor has any fiduciary obligations of management been breached. The policy of the Board and of Eberstadt from the outset was to seek to keep conflicts of interest in respect of M&D as manager and adviser of the Fund and M&D as an Eberstadt subsidiary to a minimum. This poses a real problem in the mutual fund field, see Comment, Duke L.J. 429, 432 (1972); Note, 68 Colum L. Rev. 334 (1968); Mundheim, Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds, 115 U. of Pa. L. Rev. 1058 (1967).

For the reasons hereinafter stated, it is respectfully submitted that the District Court erred in holding that "business judgment" constitutes a defense to plaintiff's claims.

As we have shown above, defendants' use of recapturable commissions for the benefit of M&D resulted in flagrant self-dealing at the expense of the Fund in violation of the Investment Company Act and other federal securities laws. (pp. 39 - 47 supra). Moreover, defendants' failure to disclose material facts in the Fund's prospectuses, annual reports and proxy statements concerning the fund's portfolio policy and

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Securities Exchange Act, 15 U.S.C. Sec. 78j and Rule 10b-5 thereunder, 17 C.F.R. Sec. 240. 10b-5.

the impact of that policy on the conflicting interests of the Fund and M&D violated the Securities Act, the Securities Exchange Act and the Investment Company Act (pp. 50-57, supra). Eberstadt, parent company of M&D, and Zeller, Chairman of the Board and chief executive officer of Eberstadt (Tr. 14), are liable jointly and severally with M&D not only as direct participants in the wrongs alleged, but also as aiders and abettors and as controlling persons under Sec. 48 of the Investment Company Act, 15 U.S.C. Sec. 80a-47; Sec. 20 of the Securities Exchange Act, 15, U.S.C. Sec 78t; and Sec. 15 of the Securities Act, 15 U.S.C. Sec. 77o.

A. Even if the directors had determined in good faith not to recapture, that would not excuse the failure to make proper disclosure to the shareholders.

Regardless of the correctness of the District Court's conclusion that "business judgment" constitutes a defense to plaintiff's self-dealing claim, we think it axiomatic that it does not constitute any defense to a failure to make proper disclosure in the Fund's prospectuses, annual reports and proxy statements. Defendants take the position herein that the Fund's directors knew at all times of the possibility of recapturing excess commissions but made a conscious choice not to cause the Fund to recapture. Even if that choice were not itself unlawful, defendants did not thereby relieve themselves of their obligation to make full disclosure to the shareholders of every material fact relating to recapture, including the fact that the directors'

portfolio policy permitted M&D to use recapturable commissions for its own benefit rather than the benefit of the Fund.* We know of no authority under the federal securities laws - judicial or otherwise - that would sanction a failure to disclose to shareholders a self-dealing arrangement between a company and its management, merely because the directors chose to permit the arrangement to continue as a matter of "business judgment," and the mere fact that the choice was made after consulting counsel does not excuse the failure to disclose. See Matter of Cornfeld, CCH Fed. Sec. L. Rep. (1970 - 1971 Transfer Binder) Para. 77,963 (S.E.C. 1971) at p. 80,137.

B. "Business judgment" is not a defense to plaintiff's self-dealing claim.

The record shows that since at least January 1, 1965, the directors of the Fund have knowingly permitted Eberstadt

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* Rule 20a-2(a)(1) of the SEC's proxy rules for investment companies requires that a proxy statement disclose " . . . the aggregate amount of the investment adviser's fee and the amount and purpose of any other material payments by the investment company to the investment adviser during the last fiscal year of the investment company . . . . " 17 C.F.R. Sec. 270.20a-2(a)(1). Similarly Items 25 and 33 of Form N-8B-1, used in connection with the registration of investment company securities, specifically require disclosure of all remuneration received by the investment adviser and principal underwriter during the last fiscal year , and Items 1.18 and 1.36 of Form N-1R, the annual report, filed with the SEC, requires similar information. 4 CCH Fed. Sec. L. Rep. Para 51,293 and 51,963.

and its wholly-owned subsidiary M&D to use recapturable commissions to discharge M&D's contractual obligations to the Fund. At least until December 5, 1968, the Fund could have recaptured these commissions through the "give-up" mechanism, a procedure that did not require any participation whatever by Eberstadt or M&D in the execution of Fund portfolio transactions. It is conceded that if these "give-ups" had been channeled to Eberstadt, rather than to non-executing brokers who performed services for M&D, they could have been applied in reduction of the advisory fee otherwise payable by the Fund to M&D. Instead, they were applied for the benefit of Eberstadt and M&D.* After December 5, 1968, and at least until July 15, 1973, M&D with the knowledge and approval of the Fund's board, continued to use recapturable commissions to discharge its obligations to the Fund under the management and distribution agreements. Although the abolition of "give-ups" meant that something more than mere bookkeeping entries was needed to effect recapture, a variety of recapture techniques were still available to the Fund and could have been used for the Fund's benefit (pp. 30 - 31, supra). Any thought of using these techniques was rejected,

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* Eberstadt was no stranger to the "give-up" practice. During this same period Eberstadt, as a member of the NYSE, was receiving "give-ups" in substantial amounts from other brokers which resulted from portfolio transactions executed by these brokers for other institutional customers of Eberstadt (Tr. 110 - 111).

ostensibly to protect the Fund's "image."

Under the facts of this case, we do not see how a knowing application of Fund assets for the benefit of the fund manager and underwriter can be justified or excused by resort to the "business judgment" rule. The Fund's prospectuses and proxy statements repeatedly represented to shareholders that M&D was acting as the Fund's investment adviser and principal underwriter pursuant to the terms of the Management and Distribution Agreements. Under those agreements, however, M&D was to receive certain specified compensation (viz., the management fee and the underwriting commission on sales of new Fund shares) in return for which it agreed to pay all costs and expenses in connection with the performance of the management and distribution functions. Based on the representations in the Fund's prospectuses and proxy statements, the shareholders of the Fund had every reason to believe that no portion of these costs and expenses would be paid by the Fund. Notwithstanding those representations, recapturable commissions, which represented substantial assets of the Fund, were being used to pay those obligations, and such payments, we submit, constituted a fraud on the Fund and an unlawful waste and diversion of corporate assets that were not capable of ratification by the directors or the shareholders. Matter of Cornfeld, supra; Matter of Provident Management Corp., supra; Continental

Securities Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138; Pollitz v. Wabash RR Co., 207 N.Y. 113, 100 N.E. 721.

Moreover, we do not believe that reliance on the advice of counsel has any significance in this case, even with respect to plaintiff's self-dealing claim. The District Court cited this Court's decision in Spirt v. Bechtel, 232 F. 2d 241, 247 (1956), in support of the proposition that reliance on counsel is alone sufficient to relieve the directors of liability. Apart from the fact that we think that case wrongly decided so far as that issue was concerned (see dissenting opinion of Judge Frank, 232 F. 2d at 256), the factual circumstances that led the Court to conclude that advice of counsel was a defense are significantly different from those presented here. There the Court noted:

> " . . . As the opinion below points out, the right of the corporation to a tax deduction on account of the stock options was far from clear under prior decisions of the Board of Tax Appeals and the ruling of the Acting Commissioner." 232 F. 2d at 246.

The Court went on to note (232 F. 2d at 247) that, so far as the defendants who benefited were concerned, "there did not appear to be any conflict between [their] own interest and the corporation's interest", because counsel had previously advised that it would be illegal for the corporation to claim a tax deduction.

The facts in the present case are diametrically the opposite. No one claims here that any of the defendants

ever received any advice of counsel that recapture was unlawful or that the Fund was not lawfully entitled to recapture if it chose to do so. First, it has been stipulated by the parties that recapture on the various stock exchanges has at all times been perfectly proper (see pp. 28-30, supra), and it is not disputed that until "give-ups" were abolished on December 5, 1968, and the use of "reciprocals" was limited on July 15, 1973, those techniques were at all times available for recapture purposes. Second, the only legal advice the director defendants ever sought was whether the Fund could refuse to recapture, (i.e., whether the Fund could knowingly reject the recovery of excess commissions), not whether the Fund had any right to recapture. The concern repeatedly expressed by defendants, particularly in light of the PPI Report and SEC Release No. 8239 (Exh. 89) setting forth proposed Rule 10b-10, was that they might be compelled to recapture for the Fund's benefit. The release read, in part, as follows:

> "The reasoning on which the proposed rule is based is that if, as pointed out above, a mutual fund manager has various means at his disposal to recapture for the benefit of the fund a portion of the commissions paid by the fund, he is under a fiduciary duty to do so ."

In response to that release defendants obtained the written opinion of their counsel, Sullivan & Cromwell,* on which

* Sullivan & Cromwell appears to have been counsel during the relevant period for Eberstadt and M&D as well as for the Fund. See Exh. 100. It has not been suggested that that firm was retained as "independent counsel" by the unaffiliated directors, the supposed statutory watchdogs for the shareholders, to recommend a course of action to protect their interests.

they purport to rely (Exh. 75). That opinion, unlike the advice rendered in Spirt v. Bechtel, does not state that the Fund was not lawfully entitled to recapture. On the contrary, it acknowledges the position of the SEC as set forth in Release No. 8239 but goes on to say that " . . . assuming the Board of Directors has considered all the relevant facts . . . ", the existing portfolio policy can be continued.* Accordingly, that opinion does not provide any proper basis upon which the defendant directors could rely in permitting Eberstadt and M&D to apply for their own benefit assets belonging to the Fund.

Conclusion

For the reasons stated, we respectfully submit that the judgment entered in the District Court should be reversed and that this action should be remanded to that Court for a trial on the issue of damages.

Dated: New York, N.Y.
November 17, 1975

Respectfully submitted

ABRAHAM J. BRILL
Attorney for Plaintiff
10 East 40 Street
New York, N.Y. 10016

Leonard I. Schreiber
Of Counsel

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* The opinion itself is remarkable in several respects. First, it makes no mention whatever of the SEC's statement that a fund manager has a fiduciary duty to recapture if he has the means to do so. Second, the opinion does not contain any evaluation of either the facts or the law. It merely says, in effect, "you don't have to recapture if you don't want to."

375—Affidavit of Service

The Reporter Co., Inc., 11 Park Place, New York, N. Y. 10007

United States Court of Appeals
For The Second Circuit

Susan Tannenbaum

Plaintiff-Appellant

against

Robert G. Zeller et al.

Defendants-Appellees

On appeal from the United States District Court for the Southern District of New York

AFFIDAVIT OF SERVICE

STATE OF NEW YORK,

COUNTY OF NEW YORK, ss:

Raymond J. Braddick, agent for Abraham J. BrillEsq. being duly sworn,

deposes and says that he is over the age of 21 years and resides at 8 Mill Lane Levittown, New York

That on the 17th. day of November, 1975

he served the annexed Brief for Plaintiff-Appellant and Appendix upon

1. Sullivan & Cromwell
Attorneys for Defendants-Appellees
F. Eberstadt & Co. Inc., F. Eberstadt & Co. Managers and Distributors Inc., and
Robert G. Zeller
48 Wall Street

New York, New York

2. Walsh & Frisch Esqs.
   Attorneys for Defendant-Appellee
   Chemical Fund Inc.,
   250 Park Avenue
   New York, New York

in this action, by delivering to and leaving with said attorneys

three true copies to each thereof.

DEPONENT FURTHER SAYS, that he knew the persons so served as aforesaid to be the persons mentioned and described in the said action.

Deponent is not a party to the action.

Sworn to before me, this 17th.

day of November, 1975

Raymond J. Burke

Roland W. Johnson

ROLAND W. JOHNSON
Notary Public, State of New York
No. 4509705
Qualified in Delaware County
Commission Expires March 30, 1977